

Unravelling the Ambiguity: The Conundrum of Preference of Payment to Statutory Dues Under IBC Law



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Despite the seemingly clear structure provided by Section 53 of the Insolvency and Bankruptcy Code, 2016 (IBC), several ambiguities and challenges complicate the practical application of the preferential payment involving government dues on the Corporate Debtor. These challenges stem from interpretational variances, the treatment of operational creditors, and the broader implications for stakeholders' involved in the Corporate Insolvency Resolution Process (CIRP). This article delves into the complexities surrounding the preference of payment for statutory dues under the IBC. It explores the legislative framework, key judicial rulings, and the implications for stakeholders, while also comparing IBC's approach to address statutory dues in the USA, the UK, and Australia with an objective to clarify the existing ambiguities and put forward suggestions to resolve them.

Read on to know more...

1. Introduction

The Insolvency and Bankruptcy Code (IBC) of India, introduced in 2016, was designed to provide a streamlined legal framework for resolving corporate insolvency and restructuring distressed companies. It aims to enhance the ease of doing business, preserve stakeholders' value,

and maintain economic stability by ensuring a time-bound resolution process.

Despite its successes, the IBC has faced challenges, particularly regarding the priority of payment for

statutory dues such as taxes and other government dues during insolvency proceedings. This lack of legal clarity on whether these statutory dues should precede creditors' claims has sparked a debate on which judicial interpretations also differ.

This article delves into the complexities surrounding the preference of payment for statutory dues under the IBC. It explores the legislative framework, key judicial rulings, and the implications for stakeholders, while also comparing India's approach with those of other jurisdictions. The objective here is to clarify the existing ambiguities and put forward suggestions to resolve them.

2. Understanding Preference of Payment Under IBC

2.1. Preference of Payment: In insolvency, certain creditors or dues are prioritized in asset distribution, following a hierarchy outlined in the IBC. Secured creditors and workmen's dues are prioritized, while statutory dues, classified as operational debts, have a debated position in this hierarchy.

2.2. Statutory Dues in Insolvency: Statutory dues, which include taxes and other public revenues, are essential for state functioning. Their prioritization in insolvency proceedings has ambiguities leading to disputes between financial creditors and the government.

2.3. Section 53 of the IBC: The Waterfall Mechanism: Section 53 of the IBC is the cornerstone of the liquidation process, providing a clear order for the distribution of proceeds from the sale of assets of the Corporate Debtor (CD). The section lists the following priority of payments:

- i. Insolvency Resolution Process Costs and Liquidation Costs:** These are to be paid in full before any distribution is made to other creditors. This ensures that the expenses incurred during the insolvency resolution and liquidation process are covered.
- ii. Workmen's Dues and Secured Creditors:** Workmen's dues for the preceding 24 months rank equally with debts owed to secured creditors who have relinquished their security. This reflects the social importance of protecting workers' rights and interests.

- iii. Employee Dues:** Wages and unpaid dues to employees (excluding workmen) for the preceding 12 months are given priority next.
- iv. Unsecured Creditors:** These include financial creditors who are not secured by collateral.
- v. Government Dues and Remaining Secured Creditors:** Statutory dues owed to the government and the remaining debts owed to secured creditors rank next in the order of priority.
- vi. Remaining Debts and Dues:** Other debts and dues, including those owed to trade creditors and suppliers, come next.
- vii. Shareholders:** Finally, any surplus is distributed to shareholders or partners of the Corporate Debtor, as the case may be with first preference for the preference shareholders, if any).

Section 53 of the IBC provides a clear order for the distribution of proceeds from the sale of the CD's assets.

3. Ambiguities and Challenges

Despite the seemingly clear structure provided by Section 53, several ambiguities and challenges complicate the practical application of the preference of payment provisions under the IBC. These challenges stem from interpretational variances, the treatment of operational creditors, and the broader implications for stakeholders involved in the Corporate Insolvency Resolution Process (CIRP).

3.1. Interpretational Variance

The IBC has faced significant ambiguity due to varying judicial interpretations on Section 53, particularly regarding the prioritization of statutory dues like taxes and government dues versus other creditors' claims. Some courts have emphasized the primacy of statutory dues, citing public interest, while others argue that financial creditors, crucial for the debtor's resolution, should not be undermined. This inconsistency has led to confusion and challenges for Resolution Professionals (RPs) managing insolvency cases as elaborated further:

3.1.1 Judicial Precedents and Interpretations

Judicial precedents play a crucial role in shaping the interpretation and application of the IBC's provisions, including those related to the preference of payment to statutory dues. However, the variance in judicial interpretations has contributed to the ongoing debate and uncertainty surrounding the preference of payment issue.

3.1.2 Landmark Cases and their Implications

The issue of preference of payment to statutory dues under the IBC has been shaped by several landmark cases, each contributing to the evolving legal framework and interpretation of the IBC's provisions. Some instances are cited below:

(a) **Innovative Industries Ltd. vs. ICICI Bank (2017)**

This case represents one of the earliest and most significant judgments under the IBC. The Supreme Court emphasized the importance of the “waterfall mechanism” detailed in Section 53 of the IBC, which ensures an equitable distribution of proceeds of assets among various classes of creditors during liquidation.

In Paragraphs 25 to 30, the court discusses the waterfall mechanism's structure, particularly how Section 53 establishes the priority of claims during liquidation. The court explains the rationale behind this hierarchy, detailing the positions of operational creditors and those with statutory dues within this framework.

Paragraphs 55 to 60 further explore the balance between the rights of operational creditors and financial creditors. The court highlights that while operational creditors, including those with statutory dues, have a level of priority, this priority is not absolute. Instead, it must be balanced against the rights of financial creditors to ensure a fair and equitable resolution process.

“The Supreme Court in the case of *Innovative Industries Ltd. vs. ICICI Bank (2017)* held that preference payment under Sec. 53 of the IBC is not absolute.”

Overall, these paragraphs are crucial in understanding how the Supreme Court set a precedent for balancing the rights of different creditor classes under the IBC, ensuring a fair distribution of assets while adhering to the principles of equitable treatment.

(b) **Creditors of Essar Steel India Ltd. vs. Satish Kumar Gupta & Ors. (2019)**

The Supreme Court examined whether operational creditors, including those with statutory dues, should be treated the same as financial creditors in asset distribution under the IBC. The court ruled that while operational creditors do have a conditional priority during liquidation, the resolution process must also safeguard the interests of financial creditors to ensure a fair and equitable outcome.

In **Paragraphs 37 to 40**, the court distinguishes between financial and operational creditors, highlighting their different roles within the IBC framework. The court explains why financial creditors are usually prioritized during the resolution process, due to their critical role in the financial structure of the CD.

Paragraphs 46 to 50 further explore the rationale for giving financial creditors precedence in the resolution process. At the same time, the judgment ensures that operational creditors are treated fairly during liquidation, balancing their interests with those of financial creditors.

The above underscores the court's reasoning in protecting financial creditors' interests while also recognizing the importance of operational creditors

in asset distribution. This balance is essential to achieving the IBC’s goals of value maximization and economic efficiency.

(c) Rainbow Papers Case (2023)

In the Rainbow Papers case (2023), the Supreme Court gave a ruling regarding the priority of statutory dues under the IBC. The Court held that statutory dues owed to the government could be considered secured debts if a charge is created by law, thereby giving them higher priority over other creditors. This marked a departure from previous judgments and sparked debate.

Paragraphs 42 to 45 of the judgment delve into the interpretation of statutory dues and their classification as secured debts. The court's decision was based on Section 48 of the Gujarat Value Added Tax (GVAT) Act, which allows statutory dues to be treated as secured debts if a legal charge is established.

“ The Supreme Court in Rainbow Papers Case (2023) ruled that statutory dues owed to the government could be considered secured debts if a charge is created by law. ”

Critics argue that this ruling undermines the principle of equitable distribution under the IBC and could have negative consequences, such as reducing credit availability and increasing litigation. Proponents, however, believe it upholds public interest by ensuring that government dues are protected.

This case highlights the need for greater judicial consistency in applying the IBC's provisions, particularly regarding the treatment of statutory dues and their priority in asset distribution.

3.2. Judicial Approach to Balancing Competing Interests

The judiciary's approach to the preference of payment issue under the IBC has evolved, shifting from an initial focus on equitable distribution

among creditors to a more recent emphasis on the public interest in statutory dues and the effects of insolvency on government’s revenue. This change reflects the broader challenges of interpreting the IBC amid a dynamic economic landscape. The judiciary's role in clarifying the treatment of statutory dues and balancing competing interests is crucial for the IBC’s effectiveness and for maintaining stakeholders’ confidence in the CIRP.

3.3. Legislative Framework and Regulatory Guidance

The legislative framework under the IBC offers a broad structure for asset distribution but lacks detailed guidance on statutory dues, leading to ambiguities.

3.3.1 Section 53 of the IBC: This section outlines the waterfall mechanism for debt settlement but is vague on how statutory dues are treated compared to other claims. This lack of specificity has led to inconsistency in judicial interpretations. Policymakers may need to amend Section 53 to clarify how statutory dues should be identified, classified, and settled.

3.3.2 Role of the Insolvency and Bankruptcy Board of India (IBBI): In the absence of legislative clarity, the IBBI provides essential guidance through Regulations and Guidelines, particularly pertaining to preparation of the Resolution Plan and conducting CoC (Committee of Creditors) meeting. However, regulatory guidance alone is insufficient. Therefore, comprehensive legislative reforms are necessary for consistency and predictability in insolvency resolutions.

3.4. Treatment of Operational Creditors

Statutory dues are classified as operational debts under the IBC, alongside dues owed to suppliers and employees. As regards the operational creditors, including those with statutory dues, the priority provisions for asset distribution, as per Section 30 (2)(b) of the IBC, are conditional and often lead to disputes. The uncertainty over how operational creditors should be treated has raised

concerns about fairness, especially when a debtor's assets are insufficient to satisfy all claims.

The ambiguity surrounding the treatment of operational creditors has also led to disputes between creditors, with financial creditors often arguing for a higher priority. This has raised questions about the fairness and effectiveness of the IBC's framework for resolving insolvency cases, particularly in cases involving large amounts of statutory dues.

3.5. Challenges in Implementation

- (a) **Identification and Classification of Statutory Dues:** The process of identifying and classifying statutory dues is complex due to its diverse nature, which can include taxes, penalties, and other obligations owed to government authorities. The absence of clear guidelines on this matter leads to disputes, delays, and inconsistencies in the resolution process. Policymakers may need to develop detailed guidelines to help accurately classify and prioritize these dues.

“ Policymakers may need to develop detailed guidelines to help accurately classify and prioritize government dues. ”

- (b) **Achieving Equitable Distribution:** Balancing the priority of statutory dues with the rights of other creditors is challenging, especially given the varying judicial interpretations of Section 53 of the IBC. This lack of consensus can lead to prolonged litigation and reduced recovery for all stakeholders. A consistent judicial approach and possible legislative reform are needed to ensure a fair distribution of assets.
- (c) **Judicial Delays and Litigation:** Prolonged litigation and judicial delays, exacerbated by the complexity of insolvency cases and the high volume of cases, create uncertainty and inefficiency in the resolution process. These delays can lead to significant economic costs, including asset value erosion and increased litigation expenses. Expedited procedures, specialized insolvency benches, and enhanced judicial capacity are necessary to address these delays.
- (d) **Stakeholder Alignment:** Conflicts between

the interests of various stakeholders, such as government authorities, financial creditors, and operational creditors, pose challenges in achieving consensus on payment preferences. This misalignment can lead to prolonged disputes and delays in the resolution process. Constructive dialogue, clear guidance from policymakers, and judicial intervention are needed to foster alignment and build trust within the insolvency ecosystem.

4. Impact on Stakeholders

- (a) **Government Authorities:** Ambiguity in the treatment of statutory dues affects government revenue, fiscal planning, and public services, potentially leading to prolonged litigation and delayed settlements.
- (b) **Financial Institutions:** Uncertainty about priority of statutory dues impacts recovery prospects, risk management, and credit risk assessments, necessitating more sophisticated models and advocacy for clearer legislative provisions.
- (c) **Operational Creditors:** These creditors face financial vulnerability due to unclear entitlements and potential disputes, requiring active engagement in the resolution process to protect their interests.
- (d) **Resolution Professionals:** They navigate complex legal and regulatory challenges, requiring specialized training and consensus-building among stakeholders to manage the preference of payment issues effectively.

5. Case Studies and Comparative Analysis

Examining case studies and insolvency frameworks from other countries can offer valuable insights into addressing the preference of payment issue under the IBC. Learning from how other jurisdictions balance creditor and government interests can help policymakers and practitioners improve the effectiveness of India's insolvency resolution framework.

5.1. United States of America (USA) Bankruptcy Code

- ◆ **Framework:** Under Chapter 11, statutory dues like taxes are classified as administrative expenses, prioritized over unsecured creditor claims.
- ◆ **Flexibility:** The Bankruptcy Code allows for the restructuring of statutory dues and the negotiation

of payment plans with government authorities.

- ◆ **Lesson for IBC:** The USA approach emphasizes clear guidelines on statutory dues' priority while allowing flexibility, balancing government and creditor interests in corporate reorganizations.

Cross-References Summary:

Administrative Expenses Priority: 11 U.S.C., 503, 507(a)(2)

Restructuring Flexibility: 11 U.S.C., 1123(a)(5)(G), 1129(a)(9)(C)]

Statutory Dues Priority: 11 U.S.C., 507(a)(8), 1129(a)(9)(A)

These sections and provisions highlight the USA's Bankruptcy Code's structured yet flexible approach to managing statutory dues during corporate reorganizations.

5.2. United Kingdom Insolvency Act

- **Framework:** The Insolvency Act prioritizes statutory dues, such as taxes and National Insurance contributions, as preferential debts, requiring settlement before unsecured creditors.
- **Flexibility:** The Act permits negotiation and restructuring of statutory dues, ensuring an equitable and efficient resolution process.



- **Lesson for IBC:** The U.K. approach highlights the importance of clear priority guidelines for statutory dues while maintaining flexibility in their treatment, promoting fairness in asset distribution.

Cross-References Summary:

- **Preferential Debts Priority:** Sections 386, Schedule 6 (Paragraphs 4, 7), 175, 176ZA
- **Restructuring Flexibility:** Sections 213, 110, 112
- **Fair Distribution:** Sections 175, 176A, 176ZA

These sections of the UK Insolvency Act 1986 illustrate how the UK prioritizes statutory dues while allowing

flexibility in their negotiation and restructuring, promoting a balanced approach in insolvency proceedings.

5.3. Australian Corporations Act

- **Framework:** The Corporations Act establishes the principle of *pari-passu* in distribution of a company's assets during Liquidation. As per Section 555 thereof, debts and claims proved are to rank equally except as otherwise provided.
- **Flexibility:** It allows for restructuring statutory dues and negotiating payment plans with authorities.
- **Lesson for IBC:** The Australian model offers clear guidelines on statutory dues' priority and treatment, ensuring a balanced approach that supports both government interests and corporate reorganization.

Cross-References Summary:

- **Priority Debts:** Sections 555, 556(1)(e), 556(1)(g)
- **Restructuring Flexibility:** Sections 447A, 444A, 444DA
- **Guidelines on Priority:** Sections 555, 560, 561

These sections and provisions of the Australian Corporations Act 2001 highlight the structured and flexible approach Australia takes in managing statutory dues during insolvency, balancing government interests with the need for corporate reorganization.

These international frameworks provide valuable insights for the IBC, highlighting the need for clear guidelines on the priority of statutory dues while incorporating flexibility to balance the interests of all stakeholders in insolvency proceedings.

6. Recommendations for Navigating the Way Forward

To address the ambiguity surrounding the preference of payment to statutory dues under the IBC and enhance the insolvency resolution process, the following measures are suggested:

- (a) **Legislative Reforms:** Amend Section 53 of the IBC to clearly define the treatment of statutory dues relative to other creditor claims, reducing interpretational variance and ensuring consistency.

- (b) **Judicial Consistency:** The judiciary should aim for consistent interpretations and establish binding precedents to provide clear guidance on the preference of payment issues.
- (c) **Stakeholder Engagement:** Encourage dialogue among stakeholders, including government authorities and creditors, to align interests and inform policy decisions.
- (d) **Capacity Building and Training:** Enhance training for Resolution Professionals and judicial officers on the IBC's provisions, judicial rulings, and stakeholder management.
- (e) **Comparative Analysis and Best Practices:** Learn from insolvency regimes in other countries and

adopt best practices to improve India's insolvency resolution framework.

7. Conclusion

The preference for payment of statutory dues under the IBC is a complex issue that affects the CIRP, creditors' recovery, and financial stability. The ambiguity in handling these dues alongside other creditor claims necessitates careful policy considerations and balanced solutions. To address this, legislative reforms, consistent judicial rulings, stakeholder engagement, capacity building, and adopting best practices from other countries are crucial. Clarifying the treatment of statutory dues while balancing stakeholder interests can enhance the IBC's effectiveness, promote economic efficiency, and ensure public finance sustainability.

